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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 473

JOHN H. BINGLER, DISTRICT DIRECTOR OF INTERNAL REVENUE, PETITIONER

v.

RICHARD E. JOHNSON, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The district court's instructions to the jury are not officially reported. They are unofficially reported at 19 A.F.T.R. 2d 426. The opinion of the court of appeals is reported at 396 F. 2d 258.

JURISDICTION

The judgment of the court of appeals was entered on June 5, 1968. The petition for a writ of certiorari was filed on September 3, 1968, and was granted on November 18, 1968. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether amounts, measured by prior salary and family size, paid by Westinghouse Electric Corporation to selected employees to whom Westinghouse had granted an educational leave of absence for the purpose of completing a doctoral dissertation, and who were obligated to continue in Westinghouse's employ for at least two years after the leave, are excludable from the recipient's gross income as a "scholarship" or "fellowship" within the purview of Section 117 of the Internal Revenue Code of 1954.

STATUTE AND REGULATIONS INVOLVED

Section 117 of the Internal Revenue Code of 1954 and the relevant provisions of the Treasury Regulations on Income Tax promulgated thereunder are set forth in the Appendix, *infra*, pp. 37–41.

STATEMENT

Respondents[1] were employees of the Bettis Atomic Power Laboratory in Pittsburgh, Pennsylvania, which Westinghouse Electric Corporation operates under a cost plus contract with the Atomic Energy Commission (R. 71–72, 78; Tr. 256–257, 290). Each respondent participated in the Westinghouse Bettis Fellowship and Doctoral Program, one of a variety of training programs that Westinghouse offers to its employees (R. 7–9, 60; Tr. 30–32, 226). In view of a severe shortage of qualified nuclear scientists and engineers, the Bettis doctoral program was established

[1] Messrs. Johnson, Pomerantz and Wolfe are referred to herein as "respondents". Their wives are parties solely because joint tax returns were filed for the years in question.

in 1956 to recruit and retain engineers and scientists and thereby aid in meeting the needs of Westinghouse for key professional personnel. (R. 42, 58, 76, 81–82; Tr. 154, 155, 219, 277, 300–303). The program is funded primarily by the AEC under its general contract for the operation of the Bettis Laboratory (R. 58,, 64–65, 71, 77; Tr. 220, 236, 256, 287) and is limited to engineers and scientists employed at the Bettis Laboratory who wish to seek a Ph.D. in engineering or science at either the University of Pittsburgh or Carnegie Institute of Technology (R. 9, 37, 61–62, 99; Tr. 33, 124, 227–229, Pl.'s Ex. 2). As of the date of trial in this case, approximately 60 Westinghouse employees had obtained doctorates through the Bettis program. (R. 59; Tr. 222.)

Bettis engineers participating in the program first enter a "work-study" phase, during which they hold a regular job at Westinghouse and attend classes part time[2] either at the University of Pittsburgh or Carnegie Institute of Technology (R. 12–13, 26–27, 44–45, 100–104; Tr. 39, 80, 161; Pl.'s Ex. 2). Those who complete all preliminary requirements for a doctorate—*i.e.*, course work, language studies, and qualification examinations—may apply for an "educational" leave of absence in which to complete a dissertation. Each applicant must be approved by Westinghouse and by the AEC and the topic of his proposed thesis is reviewed to ensure that it is relevant to the work program of the laboratory. (R. 61–62, 74–76; Tr. 228–229, 273–276.) Those selected must agree to work at Bettis for at least two years after completion of their leave. Earlier, when

[2] Westinghouse allows its employees up to eight hours per week (up to 156 hours each year) of paid "release time" in which to attend classes. (R. 102–103; Pl.'s Ex. 2.)

respondent Wolfe took his leave, only a one year commitment was required. (R. 8–9, 21–22, 35–36, 47–48, 62–63, 109, 110; Tr. 32, 33, 63, 116, 119, 168, 230–231; Deft. Exs. 1, 3.)

While on educational leave an engineer receives payments from Westinghouse based on a fixed percentage of his prior salary at Westinghouse plus amounts that depend on the size of his family, up to a fixed maximum. (R. 63, 106; Tr. 231–232; Pl.'s Ex. 2.) Westinghouse's internal records designate those on educational leave of absence as employees of the Bettis Laboratory. The stipends paid are charged to the indirect labor overhead of the laboratory, and Westinghouse treats these amounts as wages for withholding and social security tax purposes. (R. 68–69; Tr. 247–249.) Those on leave retain their seniority status (R. 70; Tr. 253–254) and receive all employee benefits, such as hospitalization, insurance, and stock option privileges (R. 36–37, 48, 63; Tr. 121, 169–170, 232). They continue to contribute to and accumulate rights under the Westinghouse pension plan, and are eligible for vacation immediately upon return from leave. (R. 36–37, 48, 63; Tr. 121, 169–170, 232.)

After successfully completing the work-study phase of the Bettis program, each of the three respondents in this case was granted a leave of absence for the purpose of writing a thesis on topics that Westinghouse and the AEC had approved. During leaves of nine months, respondents Johnson[3] and Pomerantz[4]

[3] Respondent Johnson was on leave from October 1, 1960, to June 30, 1961. (R. 7; Tr. 30.)

[4] Respondent Pomerantz was on leave from November 1, 1961, to July 31, 1962. (R. 8; Tr. 31.)

were each paid $5,670, representing 80 percent of their prior salaries at Westinghouse. Respondent Wolfe, whose leave lasted a year,[5] received $9,698.90, which amounted to 90 percent of his prior salary. (R. 7–8; Tr. 30, 31, 32.)

Westinghouse withheld income tax from these amounts. Respondents filed claims for refund, contending that the payments were excludable from gross income as scholarships under Section 117 of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue rejected these claims, and timely refund suits were brought in the district court.

At a consolidated trial, the court instructed the jury that (R. 90; Tr. 428–429):

> amounts of money or stipends paid to an individual to enable him to pursue studies or research are considered to be amounts received as a scholarships or fellowship grant if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity * * *.

The instructions continued, however, to note that a scholarship or fellowship does not include an amount that either represents "compensation for past, present or future employment services, or represents payment for services which are subject to the direction or supervision of the grantor" or are "paid to an individual to enable him to pursue studies or research which studies or research are primarily for the benefit of the grantor * * *." (R. 90; Tr. 429.)

[5] Respondent Wolfe was on leave from March 1, 1960, to February 28, 1961. (R. 8; Tr. 31.)

In answer to special interrogatories, the jury found that the amounts received by each respondent from Westinghouse did not constitute excludable scholarships or fellowship. (R. 89–90, 99; Tr. 428, 449.) Judgment accordingly was entered in favor of the District Director. (R. 111–112; Judgment).

On appeal the Court of Appeals for the Third Circuit reversed, holding that the amounts paid to respondents during their educational leaves of absence were excludable, and that the issue should not have been submitted to the jury.[6] (R. 129; Slip op 11.) The court reasoned that even if a payment had " 'indicia of compensation' ", it could nonetheless be characterized as an excludable scholarship. Accordingly, the court disapproved (R. 124; Slip op 5–6) the provision of Section 1.117–4(c)(1) of the Income Tax Regulations, which states that Section 117 does not encompass amounts that represent "compensation for past, present, or future employment services." It also ruled that the amounts paid respondents were not compensation for future employment at Westinghouse, since respondents, after completing their doctorates, were to be paid at a rate commensurate with their then education and experience. (R. 127; Slip op 9.) Finally, the court held (R. 128; Slip op 10–11) that whatever "indirect advantage" the Bettis program gave Westinghouse was beyond the scope of Section

[6] Because respondents did not move for either a directed verdict or judgment n.o.v. at trial, we interpret the decision below as calling for a new trial and not the entry of judgment for respondents. See *Globe Liquor Co.* v. *San Roman*, 332 U.S. 571; *Cone* v. *West Virginia Paper Co.*, 330 U.S. 212; *Johnson* v. *New York, N.H. & H.R. Co.*, 344 U.S. 48, 54, n. 3.

1.117-4(c)(2) of the Regulations, which states that amounts "paid or allowed to * * * an individual to enable him to pursue studies or research primarily for the benefit of the grantor" are not a "scholarship" or "fellowship".

SUMMARY OF ARGUMENT

The Westinghouse program under which respondents received 80 or 90 percent of their prior salary while completing their doctoral theses is typical of a variety of programs sponsored by private and public employers that allow an employee to complete a graduate degree while continuing to receive all or substantially all of his prior salary. The question here is whether amounts employees receive under such programs fit within the exclusion from gross income of amounts received as a "scholarship" or "fellowship" that Congress created when it enacted Section 117 of the Internal Revenue Code of 1954.

The statute does not provide a general definition of these terms. However, Congress plainly expressed the view that the exclusion would not apply to grants that are "in effect merely payments of a salary during a period while the recipient is on leave from his regular job." H. Rep. No. 1337, 83d Cong., 2d Sess. 17; *accord,* S. Rep. No. 1622, 83d Cong., 2d Sess. 18. To the extent that Congress could foresee such arrangements, it expressly prohibited or limited the tax exemption. Thus Section 117(b)(1) requires that taxable income include amounts students receive in return for teaching, research or other services. Section 117(b)(2) requires that non-degree candidates include in income

grants received to finance research or study, except for those paid by governmental, charitable or other tax exempt organizations, and then the exclusion is limited to $300 per month up to a maximum of three years.

The Treasury has implemented this expression of Congressional purpose in regulations that define the terms "scholarship" and "fellowship". These Regulations provide that, generally speaking, scholarships and fellowships are amounts paid to or for the benefit of an individual, to aid him in study or research. The Regulations, however, then specifically exclude from the meaning of "scholarships" and "fellowships" payments which represent compensation for past, present or future employment services or which are paid primarily for the benefit of the grantor. The definition of the Regulations provided the basis for the instructions given the jury at the trial of this case.

Prior to the decision below, four circuits, the Court of Claims, and the Tax Court agreed that bargained-for payments such as respondents received here are not "scholarships" or "fellowships". The Third Circuit, however, here held invalid the "compensation" test, and construed the alternative "primary purpose" test of the regulation as meaning a test of who benefits the most from the studies or research rather than what is the primary purpose of the grant itself.

Contrary to the apparent view of the Third Circuit, Congress did not enact Section 117 simply to eliminate income tax on payments made to support a per-

son who is studying or performing research. The legislative history shows an intent to exempt only relatively small amounts paid to students who would not otherwise have a substantial tax liability. At the same time Congress made clear its purpose to tax continuing salary payments to people on leave from their regular jobs, as was so plainly the case here.

Respondents' entire arrangement with Westinghouse was bargained for; two of the respondents expressly acknowledged the importance this program played in their decision to accept employment with Westinghouse. They received a doctorate, while supported by Westinghouse, in exchange for a commitment to remain with Westinghouse for two years after completing their study. The arrangement relieved Westinghouse of the need to recruit qualified engineers in a highly competitive market, and respondents gave up their freedom to negotiate for jobs on the open market for a period of two years.

Moreover, the work done by the respondents fit into the over-all research program of the Bettis Laboratory, which was run by Westinghouse and the Atomic Energy Commission. While the opportunity to get a Ph.D. at Westinghouse's expense unquestionably assisted the recipients in the pursuit of their studies, it constituted a very attractive fringe-benefit that induced respondents to accept employment with Westinghouse. The payments to respondents can reasonably be characterized only as compensatory in nature, made primarily to benefit Westinghouse, and the decision below is wrong in allowing these payments to be excluded from the recipients' income. It should be re-

versed here, and the judgment of the district court should be reinstated.

ARGUMENT

INTRODUCTION

The respondents in this case received stipends from their employer, Westinghouse, while on educational leave to complete work on doctoral degrees in engineering. Only selected employees of Westinghouse were eligible for this program. (R. 9, 62; Tr. 33, 229–230.) Respondents retained employee status during their graduate work (R. 36–37, 48, 63, 68–69; Tr. 121, 169–170, 232, 247–249) and, as a condition precedent to receiving the stipends, they specifically obligated themselves to remain with Westinghouse for two years after completion of the Ph.D. programs. (R. 8–9, 21–22, 35–36, 47–48, 62–63, 109, 110; Tr. 32–33, 63, 116, 119, 168, 230–231; Def's. Exhs 1 & 3.) The payments to the respondents while on leave were geared to their regular salary, plus a family allowance. (R. 63, 106; Tr. 231–232; Pl's. Ex. 2.)

Numerous employers provide similar programs for their employees. Not infrequently, as in the case of the federal government,[7] the employee receives his full

[7] See Rev. Rul. 64–71, 1964–1 Cum. Bull. (Part I) 82, which deals with grants by the National Institute of Public Affairs to enable Government employees to attend selected universities for an academic year of study. Although not mentioned in the ruling, the Government Employees Training Act, 5 U.S.C. 4101–4118, requires participants to return to the government for a period three times as long as the leave. See 5 U.S.C. 4108. The Internal Revenue Service allows exclusion from income of amounts the Institute paid to cover tuition, books and classroom expenses. However, the continuing salary payments the recipients received from the department, bureau, or agency where they were employed are includible in income. Here, the

salary while on educational leave. Ordinarily, the recipient promises—generally in a written contract[8]—to work for the employer for a specified period of time after his leave. Thus the employee surrenders his future freedom to bargain and the employer is relieved of the need to recruit a highly trained replacement in a tight labor market.

The issue in this case arises under Section 117 of the Internal Revenue Code of 1954. The text of this provision is set out in full in the Appendix (*infra*, pp. 37–38). Essentially, though, the question involves the proper construction of the words "scholarship" and "fellowship grant," as used in the first paragraph of the section.

As so often happens in such cases, dictionary definitions are not of much help in working out the proper

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amounts Westinghouse applied to respondents' tuition, books, and fees have been treated as not includible in their gross income. Conceptually these sums are properly includible in income, although they may be offset by an educational expense deduction. For a description of the circumstances under which such amounts may be deducted, see, generally, § 1.162–5 of the Income Tax Regulations.

[8] Compare *Mark* v. *Commissioner*, decided November 3, 1967 (26 T.C.M. 1106), involving a foreign service officer employed by the State Department, who was a fellow at the Harvard Center for International Affairs. Although no particular course of studies was required by the State Department, and the taxpayer was not required to return to his employment at the State Department at the end of his fellowship, the State Department continued to pay taxpayer's regular salary during his attendance at the Center, because it believed that the program offered valuable training for the participants and increased their qualifications for positions of higher responsibility. The Tax Court held that the payments to the taxpayer by the State Department while he was a fellow at the Center were not excludable as a fellowship grant.

ambit of these words as used in the statute. It is relevant to note, though, that both "scholarship" and "fellowship" were in origin words used in connection with Universities, and with a charitable connotation. They are not applicable, we submit, to payments made in a commercial setting, or to payments made by an employer to an employee as a part of an employment arrangement.

Neither the statutory language nor the legislative history provide conclusive guides, but it is entirely clear that Congress was of the view that it was not exempting from tax payments that were simply continuations of salary to an employee on educational leave.

This legislative view receives expression in the pertinent Treasury Regulations, which formed the basis for the instructions given the jury at the trial of this case. The Third Circuit stands alone in rejecting this interpretation; four other courts of appeals and the Court of Claims have approved the Treasury's view. We shall now turn to that history and the regulations in order to demonstrate that the amounts Westinghouse paid respondents during their leaves are exactly the type of receipts that Congress intended should not be exempted from income tax.

I. CONGRESS DID NOT INTEND THAT SECTION 117 WOULD ALLOW EXCLUSION FROM INCOME OF AMOUNTS REPRESENTING CONTINUING SALARY PAYMENTS OR WHICH ARE OTHERWISE COMPENSATORY IN NATURE

Many grants denominated "scholarships" or "fellowships" create no taxable income to the recipient because they go from grantor to recipient with no

quid pro quo required. The source might be a school, an eleemosynary organization, or an individual; but the essential characteristic is that the recipient is only a student and is not expected to provide consideration for his grant beyond continuing his studies and, perhaps, maintaining a specified level of academic achievement. The grantor might act from any one of a variety of motives; his purpose might be entirely charitable or result from an interest in the welfare of a particular student. In no event, however, would he expect or receive any benefit other than the satisfaction of providing a student with an opportunity that he otherwise might not have had. The Internal Revenue Code of 1939 and its predecessor Revenue Acts provided an acceptable method of determining the tax consequences of such payments to the recipients, for such amounts qualified for the exclusion from income taxation that these laws conferred upon "gifts". See, *e.g.*, Section 22(b)(3) of the Internal Revenue Code of 1939; Section 22(b)(3) of the Revenue Act of 1928, 45 Stat. 797; Section 213(b)(3) of the Revenue Act of 1918, 40 Stat. 1065.

This approach proved unsatisfactory, however, when the Treasury, in the later 1940's, sought to deal with two other types of grants. These, while used for the support of students or researchers, differed importantly from what has traditionally been considered a "scholarship" or "fellowship". One was the foundation grant paid to a post-doctoral researcher.[9] In this

[9] See I.T. 4056, 1951-2 Cum. Bull. 8; *Stone* v. *Commissioner*, 23 T.C. 254.

instance the recipient is, in all essence, being paid to do his life's work; yet, strictly speaking, he is not receiving "salary" or "compensation" because he has no obligation to the grantor, and the grantor does not exercise day to day control over his work. If the first factor controlled, the grant would be "income"; if the second, it might be a "gift".

Comparable difficulties arose in the treatment of amounts paid research or teaching assistants, *i.e.*, graduate students who received grants and in return were expected to conduct research or teach classes.[10] Plainly the recipients were chosen only because of their student status and the payments were designed to support them while completing their education; in these respects the payments resembled fellowships. On the other hand, the recipients were employees of and required to perform services for the grantors, an obvious hallmark of taxable income.

The Commissioner of Internal Revenue had no means of resolving these difficulties except through application of the provisions that exclude "gifts" from income. Thus he ruled (I.T. 4056, 1951–2 Cum. Bull. 8, 10):

> The amount of a grant or fellowship award is includible in gross income unless it can be established that such amount is a gift. If a grant or fellowship award is made for the training and education of an individual, either as a part of his program in acquiring a degree or in otherwise furthering his educational development, no services being rendered as consideration there-

[10] See *Banks* v. *Commissioner*, 17 T.C. 1386; *Ti Li Loo* v. *Commissioner*, 22 T.C. 220.

> for, the amount of the grant or award is a gift which is excludable from gross income. However, when the recipient of a grant or fellowship applies his skill and training to advance research, creative work, or some other project or activity, the essential elements of a gift as contemplated by Section 22(b)(3) of the Internal Revenue Code are not present, and the amount of the grant or fellowship is includible in the recipient's gross income.

This approach ran into difficulty in the Tax Court. That tribunal agreed with the Commissioner in the case of research assistants, and held their grants to be taxable income. *Ti Li Loo* v. *Commissioner,* 22 T.C. 220; *Banks* v. *Commissioner,* 17 T.C. 1386. On the other hand, foundation grants to established researchers were ruled to be nontaxable. *Stone* v. *Commissioner,* 23 T.C. 254.

These results were defensible if the problem were viewed simply as one of interpreting the word "gift". But in terms of basic tax policy, the outcome was anomalous. The graduate student receiving a subsistance income—Mr. Banks' monthly stipend varied from $175 to $237.50 between mid-1947 and early 1949—was taxed because he was unquestionably an employee being paid to perform services in return for his grant. Yet the beneficiary of the foundation grant who continued his ordinary professional activities, and was paid an amount commensurate with his professional status—Mr. Stone received $3,000 from a foundation while on sabbatical from a university which continued half his regular salary for the 1950–1951

academic year—escaped taxation because the grantor proceeded from a "disinterested generosity".

To alleviate the difficulties of a rule that required a case-by-case inquiry into the question whether a "gift" was intended, Congress wrote Section 117 into the Internal Revenue Code of 1954 (H. Rep. No. 1337, 83d Cong., 2d Sess. 16; S. Rep. No. 1622, 83d Cong., 2d Sess. 17). Section 117(a) states that "gross income does not include * * * any amount received * * * as a scholarship * * * or * * * as a fellowship grant * * *." Although there is no general statutory definition of the words "scholarship" and "fellowship", the Ways and Means Committee said (H. Rep. No. 1337, *supra,* at 17, "Such grants generally are of small amount and are usually received by individuals who would have little or no tax liability in any case."

Then, special provisions were written to cover the two problems that had proved so vexing to the Treasury. Thus section 117(b)(1) specifically provides that the "scholarship" exclusion does not apply to payments made for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the grant. Then, in a provision obivously directed at situations such as that in *Stone* v. *Commissioner, supra,* Section 117(b)(2) provides that non-degree candidates may exclude grants only if they are paid by governmental agencies or charitable, educational and other tax-exempt "organizations described in Section 501(c)(3)," and then only in the amount of $300 for each month of the grant's duration, for a maximum of 36 months.

In speaking of Section 117(b)(2) the Ways and

Means Committee described its purpose in these words (*Id.* 17):

> This will tax those grants which are in effect merely payments of a salary during a period while the recipient is on leave from his regular job. Hence, in the case of persons who have completed their formal education and are continuing to teach or carry on research as part of their life work, the grant will be excluded only if it is merely a supplement to the individual's own funds which make it possible for him to carry on research or further his educational development.

The Senate rejected the House formulation of Section 117(b)(2),[11] which would have allowed exclusion only of grants that, together with compensation received from the recipient's prior employer, did not exceed 75 percent of his prior year's salary. See H. Rep. No. 1337, *supra,* at p. 17. It wrote the language that is now in Section 117(b)(2), expressing, however, the same purpose as the House (S. Rep. No. 1622, *supra* at p. 18):

> The House bill provided a specific standard for determining the taxability of grants received by individuals who are not candidates

[11] The House draft of Section 117(b)(2) was criticized on the grounds that the test discriminated against post-doctoral students, such as physicians taking advanced training in a specialty who had received no significant prior salary, and because it would increase costs to non-profit foundations which sponsored such training. See, *e.g.*, statement of Mefford R. Runyon, Executive Vice President, American Cancer Society, Hearings Before the Senate Committee on Finance, April 14, 1954, at pp. 921–924; Letter from Detlev W. Bronk to Senator Milliken, dated April 16, 1954, *id.* at pp. 1367–1368.

> for a degree, typically the recipients of post doctoral fellowships. Such grants may be in effect a continuing salary payment while the recipient is on leave from his regular job. The House bill specified that such grants are excludible only if the annual amount of the grant plus any compensation received from the recipient's previous employer is less than 75 percent of the recipient's salary in the year preceding the grant. Cases were brought to your committee's attention in which the formula of the House bill would tax grants which were clearly not a continuing salary payment. In many of these cases taxability would result from the absence of a substantial earned income in the previous year. Your committee therefore has substituted for the 75 percent rule an exclusion of $300 per month of grants paid to individuals who are not candidates for degrees. The exclusion will not be allowed beyond a total of 36 months.

See, also, *id.* at 188–190.

The thrust of the legislation and its history is clear: Generally speaking, amounts paid for the support of a scholar constitute an excludable scholarship or fellowship. On the other hand, payments are not excludable simply because their purpose is to pay the living expenses of a person who is a student, for amounts that relate to the provision of services or some other *quid pro quo* by the recipient must be included in gross income as they are in the same category as the "continuing salary payments" that Congress repeatedly said should not be exempted.

II. THE PERTINENT TREASURY REGULATIONS UNDER SECTION 117 PROPERLY IMPLEMENT THE CONGRESSIONAL PURPOSE OF DENYING THE EXCLUSION TO CONTINUING SALARY PAYMENTS AND OTHER COMPENSATORY ARRANGEMENTS

Because the statute contains no general definition of "scholarship" and "fellowship", the Treasury has sought to fill the void through its power to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code, 26 U.S.C. 7805(a). As this Court recently held (*United States* v. *Correll*, 389 U.S. 299, 306–307):

> * * * We do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Commissioner* v. *Stidger*, 386 U.S. 287, 296.

The regulations under Section 117, which four circuits and the Court of Claims have sustained, are plainly reasonable "contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons." *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501.

Scholarships and fellowships are, of course, amounts paid to support a student or scholar while he is pursuing studies or independent research, and this is the

position taken in the relevant Treasury Regulations. Thus Section 1.117–3(a) and (c) of the Income Tax Regulations provide (Appendix, infra, pp. 39–40): "A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies." On the other hand, it is equally clear that a payment is not a "scholarship" or "fellowship" merely because it is used to support an individual engaged in study or research. Payments which result from a bargained-for transaction or are a *quid* given for the recipient's *quo* do not fit the common understanding of those words.[12] At the very least, as the court of appeals recognized in the present case (R. 127; Slip Op 9.):

> A significant commitment by the student in return for a grant would, of course, place that grant outside the category "scholarship", at least to the extent of the value of that commitment. For if the grantee had to barter for his stipend, giving full value for it, this arrangement would hardly serve the primary purpose of the Section 117 exclusion: to encourage financial aid to education through tax relief.

[12] Thus, see National Industrial Conference Board Publication No. 209, Combating Knowledge Obsolescence: I. Company Fellowship Plans (1968). This report analyzes (*id.*, ii) 75 "fellowship" plans sponsored by 60 corporations. Under those plans "no student is ever *required* to agree to employment as a condition of receiving a fellowship", even though most of the grantors hope to recruit the recipients of their funds (*id.*, 6). The only string attached to any of these grants has to do with patentable inventions developed by the recipient during his graduate study. Some, but comparatively few, of the grantors reserve title or a royalty free license to such inventions; most, however, do not (*id.*, 59–60).

As we have shown above, Congress is in obvious agreement with this view, for to the extent that it foresaw such compensatory arrangements, it expressly forbade or limited the tax exemption in Section 117 (b). In a similar vein the applicable Treasury Regulations, following the general definition of "scholarship" and "fellowship", provide (Section 1.117–4(c)) (Appendix, *infra*, pp. 40–41):

> § 1.117–4 *Items not considered as scholarships or fellowship grants.*
>
> (c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.* (1) Except as provided in paragraph (a) of § 1.117–2 [not relevant here] any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.
>
> (2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.
>
> * * * * *

Thus, under the first paragraph of the regulation, amounts that represent compensation for past, present or future employment—*i.e.*, paid from the employer to an employee—are not considered a scholarship or fellowship. This is a simple and direct implementation of the Congressional expression that exemption should not be allowed to continuing salary payments to an

employee who is on leave from his regular job. To this the Treasury added a second provision, holding that a scholarship or fellowship does not include amounts that finance study or research undertaken "primarily for the benefit of the grantor". By this paragraph, the Treasury has supplemented the first in order to impose tax on bargained-for arrangements that do not create an employer-employee relation, as, for example, in the case of an independent contractor. But the general idea is the same: "scholarship" or "fellowship" does not include arrangements where the recipient receives money and in return provides a *quid pro quo*.

III. THIS COURT SHOULD FOLLOW THE DECISIONS OF FOUR CIRCUITS AND THE COURT OF CLAIMS ACCEPTING THE FORMULATION OF THE TREASURY REGULATIONS WHICH FORMED THE BASIS FOR THE INSTRUCTIONS GIVEN THE JURY HERE

In this jury case, the rule of law applied at trial was that expressed in the instructions given the jury, and those (see p. 5 *supra;* R. 86–96; Tr. 420–441) were in substance the same as the regulations. Under that definition of "scholarship" and "fellowship", Westinghouse's payments to respondents must fail to qualify for exclusion from taxation. The opportunity to obtain a doctorate while supported by Westinghouse was a valuable fringe benefit that strongly influences an engineer to enter into Westinghouse's employ (R. 22, 34–35; Tr. 66, 113, 115–116.)

Working for Westinghouse during the work-study phase was the first requirement of the later, paid leaves of absence. (R. 104; Pl's. Exh. 2.) Westinghouse would not have paid the so-called "stipends"

but for respondents' commitments to work for one or two additional years (R. 62–63; Tr. 230–231), and their choice of theses topics that fit into the overall research program of the Bettis Laboratory. (R. 61–62, 74–75; Tr. 228–229, 273–275.) The payments were simply continuing salary payments to employees who were granted leave so that they might upgrade skills required by Westinghouse, requirements that Westinghouse otherwise could not have so readily fulfilled. (R. 42, 58, 76, 81–82; Tr. 154–155, 219, 277, 300–303.) As two of the respondents testified, the availability of the Bettis program was a strong inducement in their decisions to accept employment at Westinghouse.[18] Westinghouse avoided the need to recruit new people, and respondents increased their skills and attractiveness to Westinghouse, and surrendered their freedom of choice of employers for a significant period of time.

Under the instructions, the jury, we submit, had no choice but to find for the government on this record; at the very least the record has an adequate base for the jury verdict if the Treasury's Regulations on which the instructions were based are a valid interpretation of the words "scholarship" and "fellowship."

1. Four courts of appeals and the Court of Claims have sustained the Regulations that the Third Circuit

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[18] Mr. Pomerantz testified that in interviewing with Westinghouse, he was interested not only in a job but in a job which would allow him to continue his education. (R. 22; Tr. 66.) Mr. Johnson testified that of the items he considered in accepting the job with Westinghouse, the doctoral program was most important, the salary second, and the fringe benefits last. (R. 35; Tr. 115.)

refused, to apply here. The first case was *Ussery* v. *United States*, 296 F. 2d 582, where the Fifth Circuit held that Section 117 did not allow a taxpayer to exclude from gross income monthly stipends he received from the Mississippi Department of Public Welfare, which had granted him educational leave while he secured his Master's Degree in social work. While on leave the employee was given the benefit of all automatic salary adjustments, accrued annual and sick leave, retirement benefits, and workmen's compensation. He was bound to return to the department after completing his studies. In sustaining Section 1.117–4 (c)(2) of the Regulations as a reasonable interpretation of the statute, the court reasoned (296 F. 2d at 586):

> There is nothing in the legislative history to indicate that the statute was designed to exclude from gross income all payments made to enable individuals to participate in a program of educational value. It is a fair inference that the terms "scholarship" and "fellowship" were used as opposed to a term such as "compensation" and were carefully selected to bar cases where a payment is made for work primarily for the benefit of the grantor. We conclude that the Regulation excluding such payments from the reach of Section 117 is sound and proper.

The court held that the payments in question fell within the barred category, because the purpose of the program was to train employees so that they could benefit the Department of Welfare by performing their duties more effectively.

In *Stewart* v. *United States*, 363 F. 2d 355, the

Sixth Circuit considered the case of a taxpayer who received an educational leave and grant from her employer, the Tennessee Department of Public Welfare, to pursue a master's degree in social work. The Sixth Circuit ruled (*id.*, 357) that the payments she received were includible in gross income because the factors present, *i.e.*, her contractual obligation to return to the employ of the department upon completion of the leave, and her retention of Civil Service status, retirement and other fringe benefits, were such "indicia of 'compensation for past, present or future services'" as to be excluded from the definition of "scholarship" and "fellowship" under the Regulation. Even though no services were performed for the grantor during the leave of absence, the evidence of a continuing employment relationship between the grantor and recipient was so strong that the court concluded (*ibid.*) "that here the stipend was compensation for past and future services."

In like manner, the Court of Claims decided in *Reiffen* v. *United States*, 376 F. 2d 883, that gross income must include amounts paid to an employee of M.I.T.'s Lincoln Laboratory who was assigned no work responsibility during an eight month period while he was a full time graduate student, completing research and other requirements for a Ph. D. in electrical engineering. Because the primary purpose of the program was to enable Lincoln to compete with industry and other organizations in the recruitment and retention of scientific and professional personnel, the court, resting on and approving Regulation Section 1.117–4(c), held that Lincoln's payments were made to

enable the engineer to pursue studies and research primarily for the benefit of Lincoln.

In *Reese* v. *Commissioner*, 373 F. 2d 742, the Fourth Circuit affirmed, *per curiam*, a Tax Court decision, 45 T.C. 407, that payments received by a student-teacher from the County Board of Education for one semester of teaching, which was a degree requirement, did not constitute an excludable scholarship because such payments were in fact compensation for services rendered. In *Woddail* v. *Commissioner*, 321 F. 2d 721 (C.A. 10), the Veterans Administration had supported a resident in psychiatry and neurology who obligated himself to remain an employee of the Veterans Administration for a specified time in return for each year of resident training. The Tenth Circuit held that the amounts paid to the taxpayer must be included in his gross income because (321 F. 2d at 724) "it was an amount paid for services and was primarily for the benefit of the grantor." Decisions of the Tax Court and various district courts are in accord.[14]

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[14] See also *Bonn* v. *Commissioner*, 34 T.C. 64; *Littman* v. *Commissioner*, 42 T.C. 503; *Zolnay* v. *Commissioner*, 49 T.C. 389; *DiBona* v. *Commissioner*, decided September 24, 1968 (27 T.C.M. 1055); *Kopecky* v. *Commissioner*, decided September 24, 1968 (27 T.C.M. 1061); *Mark* v. *Commissioner*, decided November 3, 1967 (26 T.C.M. 1106); *Lingl* v. *Charles* (S.D. Ohio), decided December 15, 1967 (21 A.F.T.R. 2d 419). Compare *Pappas* v. *United States* (E.D. Ark.), decided March 27, 1967 (67-1 U.S.T.C., par. 9386); *Spruch* v. *Commissioner*, decided March 6, 1961 (20 T.C.M. 324); *Wrobleski* v. *Bingler*, 161 F. Supp. 991 (W.D. Pa.); *Bhalla* v. *Commissioner*, 35 T.C. 13; *Wells* v. *Commissioner*, 40 T.C. 40; and *Peiss* v. *Commissioner*, 40 T.C. 78, where the respective courts upheld the regula-

2. The Third Circuit stands virtually alone in its approach to the problem.[15] It said of Section 1.117–4(c)(1) of the Regulation, which denies the exclusion to "compensation for past, present, or future employment services" (R. 124; Slip Op 5–6):

> In light of the aim explicit in the legislative history of doing away with the touchstone of

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tion, but found as a matter of fact that the primary purpose of the payments in those cases was to further the education and training of the recipient.

[15] *Evans* v. *Commissioner*, 35 T.C. 720, acquiescence 1965–1 Cum. Bull. 4, where the taxpayer was obligated to work for her grantor upon completing her studies or to refund the sums advanced, may be consistent with the Third Circuit's position. Although *Evans* may be distinguished in that the recipient was not and had never been employed by the grantor when she received her stipend (see Rev. Rul. 65–146, 1965–1 Cum. Bull. 66), the Internal Revenue Service has advised the Assistant Attorney General in charge of the Tax Division that because the Service is of the view that a grant conditioned on future employment is not a fellowship or scholarship, the *Evans* acquiescence will be modified.

See, also, *Broniwitz* v. *Commissioner*, decided September 30, 1968 (27 T.C.M. 1088), which held that stipends paid to a degree candidate, a full-time student directing his own course of study, not obligated to work for the grantor after receiving his degree, were excludable under Section 117, even though he was required to work for the grantor during the summer when he was nominally carried on the grantor's rolls as an employee. Although the Tax Court judge cited *Johnson* v. *Bingler* with approval, he concluded (*id.*, 1092):

> In the instant case the fact situation is much stronger than it was in *Bingler*, *supra*. Petitioner was not an employee of Raytheon in any meaningful sense prior to receiving the fellowship. * * * Neither was petitioner obligated in any way to perform any services for Raytheon upon graduation. * * *; in fact, he went to work for North American Aviation shortly after he was awarded his doctorate.

> compensation versus gift, we cannot say, as one court has, that "indicia of compensation" such as are suggested by the regulation are legitimate criteria for testing the excludability of an alleged scholarship, *cf. Stewart* v. *United States*, 363 F. 2d 355, 357 (6th Cir. 1966). Nor can we even approve the disqualification added by Treas. Reg. §1.117–4(c)(1) (1956) of amounts which represent "compensation for past, present, or future employment services," without more. *Contra, Ussery* v. *United States*, 296 F. 2d 582, 586–87 (5th Cir. 1961). This ruling seems merely an attempt to write into the regulations a concept which was considered and intentionally rejected by the Congress which enacted the Code.

This analysis, however, is directly refuted by the legislative history. Although Congress did seek a solution more appropriate than a determination of whether a "gift" was intended, it did not intend to avoid an inquiry into whether a particular arrangement represented compensation for services; indeed both the House and Senate Committees show exactly the contrary. Far from reading into the regulations a "concept which was considered and intentionally rejected by the Congress", Regulation Section 1.117–4(c)(1) finds its direct antecedent in Congress' own expressions of its purposes.

The record here is conclusive in its showing of the type of situation that Congress intended not to exempt from taxation. From the beginning there was a continuing employment relationship between Westinghouse and respondents. Participation in the doctoral program was restricted to regular employees of Westinghouse. (R. 9, 62, 99; Tr. 33, 229; Pl's. Ex. 2.) Prior

to their "leaves of absence", taxpayers worked at Westinghouse under a "work-study" arrangement, whereby they were allowed "release time" from their jobs to attend classes required for their degrees. (R. 104; Pl's. Ex. 2.) Thereafter, they were required to remain with Westinghouse.

Westinghouse's internal records designated those individuals on educational leaves of absence as employees of the Bettis Laboratory. (R. 68–69; Tr. 247–249.) They continued to participate in the company health insurance, life insurance, pension plans and employee stock option plans. (R. 36–37, 48, 63; Tr. 121, 169–170, 232). Retirement benefits, seniority benefits and vacation benefits continued to accrue without interruption during the leave. (R. 36–37, 48, 63; Tr. 121, 169–170, 232.) The stipends paid during the leave were based on a fixed percentage of the recipient's prior salary, plus a family allowance, up to a fixed maximum. (R. 63; Tr. 231–232.) They were substantial in amount, representing either 80 or 90 per cent of the recipient's prior salary. (R. 7–8, 106; Tr. 30–32; Pl's. Ex. 2.) The payments were charged to the indirect labor overhead of the laboratory (R. 68–69; Tr. 247–249), and Westinghouse treated those amounts as wages for withholding and social security purposes. (R. 68–69; Tr. 247–249.) The AEC contract with Westinghouse had no provisions for offering scholarships or fellowships, but while on leave respondents were paid under this contract as employees, with the AEC refunding most of the payments to Westinghouse. (R. 68, 77; Tr. 248, 287–288.)

Each was obligated to return to Westinghouse's employ. (R. 8–9, 21–22, 35–36, 47–48, 62–63, 109, 110;

Tr. 32–33, 63, 116, 119, 230–231, Def's. Exs. 1 & 3.) Thus the amounts were "continuing salary payments to an employee on leave from his regular job"—just what Congress said should not be considered a tax exempt "scholarship" or "fellowship" (H. Rep. No. 1337, *supra*, at p. 17; S. Rep. No. 1622, *supra*, p. 18). The amounts paid to respondents are not the relatively small sums given to people who would not be expected to pay much tax, another characteristic Congress ascribed to the "scholarships" and "fellowships" to which it was granting exemption. (H. Rep. No. 1337, *supra*, at p. 17). Indeed, if the decision of the Third Circuit is sustained, the many people in respondents' position will receive exactly the windfall allowed to the taxpayer in *Stone* v. *Commissioner*, *supra*, under the 1939 Code, even though Congress thought it had, in Section 117(b)(2), limited such freedom from tax to people receiving relatively small stipends, from government or charitable organizations, before they entered upon their life's work.

The court below itself recognized that (R. 127; Slip Op. 9) "A significant commitment by the student in return for a grant would, of course, place that grant outside the category of a 'scholarship', at least to the extent of the value of that commitment." But it is not necessary, as that court thought (R. 127; Slip Op. 9), for the recipient to agree to work for less than a "'commensurate' salary" after completing his degree or to enter into a specifically enforceable contract. Freedom to bargain was surrendered; at the least, respondents for two years lost their chance to

bargain for a salary better than Westinghouse's average. And if any of them failed to live up to his promise to return to Westinghouse, he would be liable for the latter's out-of-pocket costs. For, the party agrieved by breach of an agreement at least "is entitled to be reimbursed for the money actually paid out and for all reasonable and proper expenses incurred on the faith of the contract." *Harman* v. *Chambers,* 358 Pa. 516, 521–522, 57 A. 2d 842, 845; see, also, *Kerns* v. *Insurance Co.,* 11 Pa. Superior Ct. 209; *Jessup & Moore Paper Co.* v. *Bryant Paper Co.,* 129 Atl. 559; *Emerman* v. *Baldwin,* 186 Pa. Superior Ct. 561, 142 A. 2d 440.

3. As for the part of the regulation that denies the exclusion to amounts "paid * * * an individual to enable him to pursue studies or research primarily for the benefit of the grantor", the court below, quoting its prior decision in *Commissioner* v. *Ide,* 335 F. 2d 852, 855, thought it necessary to "observe and emphasize that under this regulation [§ 1.117–4(c)(2)] the determinative consideration is not the primary purpose of the grantor in subsidizing the student, but rather the primary purpose of and the primary benefit from the subsidized study." The problem inherent in this interpretation is that the studies and research pursued always benefit the student-grantee whose training or education is thereby advanced, but they directly benefit the grantor only in the case where the grantor is also interested in the thesis or other objective results of those studies and research. The Third Circuit's approach would never impose tax where the grantor will benefit only in the future, as Westing-

house did here.[16] Yet in such circumstances the payment is unquestionably part of a *quid pro quo* exchange for an obligation or services that come after or before the recipient's studies or research. Where a payment is essentially compensatory or part of a *quid pro quo* exchange, it is irrelevant that the grantor derives no immediate, direct benefit from the subsidized study. When, as here, the grantor-employer receives an agreement to give future services, he receives something of considerable consequences in the uncertain labor markets in which he does business.

Moreover, the Third Circuit's inquiry, which might be phrased "Who benefits from the study or research the most", is administratively impracticable. It requires a separate evaluation of the benefits to the grantor and those to the recipient and then, in some manner, a comparison of each. Such an exercise would be a meaningless juxtaposition of factors that are not necessarily related to one another or to the Congressional purposes.

The Commissioner's test, on the other hand, requires an examination of the program as a whole, and asks one question: what was the primary function of the support given under the particular program. And the exclusion is denied only where the answer is that the grant was made because the recipient provided the grantee with a significant and valuable consideration.

On this side of the case, the record plainly war-

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[16] This is almost always the case where the grantor is also the employer of the grantee and will always benefit by the further education and training of his employee.

ranted a verdict for the government. The opportunity to obtain a doctorate while employed at Westinghouse was part of the over-all package of salary and fringe benefits for which respondents bargained when they first entered into corporate employment. The purpose of the program then was to attract competent people, to keep them, and to make certain that they continued to work for Westinghouse after receiving a doctorate. In all of its attributes the program was designed with the thought of alleviating Westinghouse's difficulties in hiring engineers in the open market. In working for Westinghouse before their doctoral leaves, and in agreeing to return to Westinghouse thereafter, each of the respondents thus conferred a valuable benefit on Westinghouse by reducing its need to go out in the market and hunt for new people.

Moreover, the thesis work done during respondent's leave also conferred a benefit to Westinghouse, which was concededly an important factor in the structure of the Bettis program. Both Westinghouse and the Atomic Energy Commission exercised specific controls to insure the general relevance of the proposed thesis topics to the work program at Bettis. (R. 74–75; Tr. 273–274.) Significantly, conduct of this research was the only purpose of the "leave," since all other requirements of the doctorate had to be met beforehand. Some topics submitted were disapproved and subsequently withdrawn. (R. 62, 75; Tr. 229, 276.) Mr. M. Daugherty of the AEC testified (R. 75; Tr. 274–275):

> One of the specific reasons for doing this was that the Atomic Energy Commission has always

> believed that a man should have a job relatedness in his training assignments. * * *
> * * * if a man is to be trained in a specialty, then that specialty should be related to his field of interest and his work assignment or future work assignment.

The specific topics chosen by respondents were "job related"[17] and Westinghouse felt free to treat the work product as its own.[18]

Thus the benefits to Westinghouse were substantial. Of course respondents also benefited. But that was not the primary objective. The Bettis Doctoral program obviously would not have existed but for Westinghouse's needs, and its judgment, shared by the AEC, that those needs would be met through this program.

4. The correct view of the decision below was expressed in *Quasi* v. *United States* (D. Minn.), decided November 21, 1968 (22 A.F.T.R. 2d 5850), where the district court explicitly refused to follow the Third Circuit's decision: In *Quast* the taxpayer was a doctor who embarked upon a master's program in physica' medicine and rehabilitation at the University of Minnesota Medical School while he was on the staff of the Minneapolis Veterans Administration

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[17] Mr. Pomerantz testified that he worked in the heat transfer and fluid flow section of Westinghouse and that his thesis topic was the effect of increased gravity on film boiling—a problem concerning heat transfer and fluid flow. (R. 11, 15–16; Tr. 37, 46.) Mr. Johnson testified that while at Westinghouse he specialized as a mechanical metallurgist, and that his thesis topic was in the field of mechanical metallurgy. (R. 29–30; Tr. 95.)

[18] Mr. Johnson testified that his thesis was published as a Bettis document. (R. 34; Tr. 111.)

Hospital. He agreed to work for the Veterans Administration for a period of 24 months after completion of his residency, and received some $5,000 from the Veterans Administration during the first six months of 1964, while he was a full time student at the medical school and performed no services for the Veterans Administration. The Government's contention that this sum was simply salary was sustained, and the taxpayer's challenge to the validity of Treasury Regulations Section 1.117–4(c) rejected, with the court ruling (22 A.F.T.R. 2d 5859):

> To follow the view of *Johnson* would permit nearly any payment labeled "scholarship" or "fellowship" and not expressly within the restrictions of Sec. 117(b)(1) to be excluded from gross income. The court does not believe that the legislative history of this section leads to that conclusion.

Exemptions from tax are of course to be strictly construed.[18] Congress itself pointed to the way in which the exemption of Section 117 is to be restricted. That way is reasonably and correctly expressed in the Treasury Regulations.

The Bettis Doctoral Program represented an attractive fringe benefit to the employee and an assured source of scientific and professional personnel to Westinghouse. Respondents received most of their salary while on "leave" and the purpose of the leave was to allow them to engage in research on a subject of interest to Westinghouse and the AEC. In return,

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[18] *E.g.*, *Commissioner* v. *Jacobson*, 336 U.S. 28; *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46.

respondents surrendered for a significant time their freedom to solicit job offers in a highly competitive market. Congress never intended that the terms "scholarship" and "fellowship" would connote such a *quid pro quo* arrangement as the one manifested here. The jury instructions were correct, the evidence supported—indeed compelled—the verdict, and the court of appeals should have sustained the result.

CONCLUSION

The decision below should be reversed and the judgment of the district court should be reinstated.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) *General Rule.*—In the case of an individual, gross income does not include—

(1) any amount received—

(A) as a scholarship at an educational institution (as defined in section 151(e)(4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for—

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) *Limitations.*—

(1) *Individuals who are candidates for degrees.*—In the case of an individual who is a candidate for a degree at an educational institution (as defined in section 151(e)(4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition

to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) *Individuals who are not candidates for degrees.*—In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151(e)(4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) *Conditions for exclusion.*—The grantor of the scholarship or fellowship grant is an organization described in section 501(c)(3) which is exempt from tax under section 501(a), the United States, or an instrumentality or agency thereof, or a State, a Territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) *Extent of exclusion.*—The amount of the scholarship or fellowship grant excluded under subsection (a)(1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151(e)(4)).

(26 U.S.C. 1964 ed., Sec. 117.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.117-1 *Exclusion of amounts received as a scholarship or fellowship grant.*

(a) *In general.* Any amount received by an individual as a scholarship at an educational

institution or as a fellowship grant, including the value of contributed services and accommodations, shall be excluded from the gross income of the recipient, subject to the limitations set forth in section 117(b) and § 1.117–2. The exclusion from gross income of an amount which is a scholarship or fellowship grant is controlled solely by section 117. Accordingly, to the extent that a scholarship or a fellowship grant exceeds the limitations of section 117(b) and § 1.117–2, it is includible in the gross income of the recipient notwithstanding the provisions of section 102 relating to exclusion from gross income of gifts, or section 74(b) relating to exclusion from gross income of certain prizes and awards. For definitions, see § 1.117–3.

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(26 C.F.R., Sec. 1.117–1.)

§ 1.117–3 *Definitions.*

(a) *Scholarship.* A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount

of the tuition so remitted shall be considered to be an amount received as a scholarship.

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(c) *Fellowship grant.* A fellowship grant generally means an amount paid or allowed to, or for the benefit of, an individual to aid him in the pursuit of study or research. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to an individual to aid him in the pursuit of study or research. The term also includes any amount received in the nature of a family allowance as a part of a fellowship grant. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in the pursuit of study or research where the grantor is motivated by family or philanthropic considerations.

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(26 C.F.R., Sec. 1.117–3.)

§1.117–4 *Items not considered as scholarships or fellowship grants.*

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(a) *Educational and training allowances to veterans.* * * *

(b) *Allowances to members of the Armed Forces of the United States.* * * *

(c) *Amounts paid as compensation for services or primarily for the benefit of the grantor.* (1) Except as provided in paragraph (a) of § 1.117–2, any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue

studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefit to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

(26 C.F.R., Sec. 1.117–4.)

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